Manulife Asset Management

Investment Note

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Investment note: Steady the ship, few surprises at China's NPC Work Report

China's national legislature has produced the expected raft of policy announcements, but without many surprises. Although a more flexible growth target received the most attention, Manulife Asset Management Senior Asia Strategist Geoff Lewis thinks that Chinese policy makers will continue to focus on economic stability, while doing more to manage long-term financial risks. This strategy to maximize stability should work for 2017, but will require an increasingly intricate balancing act to be viable over the longer run.

China's national legislature, the National People's Congress (NPC) held its annual meeting in Beijing on 5 March. It will convene for roughly two weeks. For investors, the most important items are Premier Li Keqiang's Work Report (the Work Report), the Budget Report and the keynote speeches given by senior ministers and officials. Together, these policy announcements will give a picture of how the government currently views the economy and its likely trajectory over this year. With the important 19th Chinese Communist Party Congress (CPC) set for fall of 2017, where a group of new leaders will be selected, the government's main priority will be to promote economic stability and manage existing risks such as the growth of 'shadow banking' in the financial sector and elevated debt levels.

Figure 1[1]: NPC targets	**2017 target**	**2016 target**
Gross Domestic Product (GDP)	Around 6.5%	6.5 to 7%
Broad money supply (M2)	12%	13%
Total Social Financing (TSF)	12%	13%
Fiscal Deficit, % of GDP	3%	3%

Revised growth target for 2017

A revised growth target for 2017 was one main takeaway from Li's Work Report. Li stated that growth for 2017 would be 'around 6.5%, or higher if possible in practice[1]. This was a marginal change in language from the annual growth target of '6.5% to 7.0%' adopted in last year's 13th Five-Year Plan. The government, however, still views 6.5% as a floor for economic growth with hopes to

[1] *Source:* REPORT ON THE WORK OF THE GOVERNMENT, Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017 by Premier of the State Council; *Bloomberg, 5 March 2017. https://www.bloomberg.com/news/articles/2017-03-05/china-s-li-walks-knife-edge-on-growth-as-graver-risks-loom*

achieve more. The revision was not a surprise. President Xi Jinping had set the stage for it in December 2016 when he publicly stated that slower economic growth was acceptable if it minimized growing risks in the economy. Li announced marginally lower target growth rates for retail sales and fixed asset investment to emphasize this point.

Monetary policy from ‘accommodative’ to ‘neutral’

Although a more flexible growth target gives the government additional room, challenges still exist reigning in credit expansion. Li’s Work Report emphasized a change in monetary policy stance from ‘accommodative’ to ‘neutral; however, that shift has been discussed before and proven difficult to implement. To emphasize this point, the Work Report set lowered growth goals for Total Social Financing (TSF) and M2 money supply by 1 percentage point (from 13% to 12%). This is a marginal decrease but not severe enough to be interpreted, as some analysts have suggested, as monetary tightening. Indeed, amidst concerns of credit expansion, credit growth has still remained elevated: TSF and M2 money supply growth outstripped nominal GDP growth in 2016[2]. The government may use monetary policy more sparingly but fiscal policy may still play a major role: the fiscal deficit target for 2017 was fixed at 3%, the same as in 2016). The government has additional fiscal room through utilising off-balance sheet fiscal deposits, which last year injected an additional 0.8% of GDP.

Supply side reform continues

Supply side reform, another formidable challenge, was emphasized but not substantively addressed. Li’s Work Report reduced targets for steel and coal capacity for 2017: steel output will be reduced by 50 metric tons, while coal producing facilities will be reduced by 150 metric tons. These targets are less aggressive than last year, although those were not likely met, and other oversupplied commodities, such as aluminium, were not addressed by the government. This may be a problem as evidence suggests that overcapacity in the Chinese economy may be getting worse. Capital Economics recently estimated that two thirds of sectors responsible for industrial output suffer from over capacity[3]. Part of the problem is that even though policy is made in Beijing, it is executed locally- reducing oversupply often times results in higher unemployment for State

[2] Source: Bloomberg, 12 January 2017. https://www.bloomberg.com/news/articles/2017-01-12/china-credit-expansion-exceeds-estimates-as-loan-demand-rises

[3] Source: Capital Economics. China Economic Focus ‘Deeper Capacity Cuts Needed to Avert Protracted Slowdown.’ 1 March 2017.

Owned Enterprise workers. But putting off action may have long-term consequences, including an increase in ‘zombie firms’ and a decrease in the sustainable growth rate.

Lower defence budget to GDP

On the Budget Report side, the most notable announcement involved defence spending. Indeed, one area where China does not appear to be making major policy changes on account of Mr. Donald Trump is defence. The 7 per cent increase in the defence budget is the lowest since 2010. As a proportion of GDP the defence budget stays at just 1.3 per cent, or well below the two per cent target recommended for NATO members[4]. China is in the process of reducing its military personnel by 300,000 to a total of 2.3 million, as the emphasis switches away from numbers towards better equipment and technology. This is a policy which has been a source of discontent among Chinese veterans, resulting in some protests in Beijing recently over redundancy payments.

Although the Work Report did not provide any surprises, it crystalized numerous policies announced earlier. China’s economic transition toward consumption will continue, albeit at a slower pace, as the government promotes stable growth. This strategy, however, has its own risks. Indeed, not exacerbating existing issues related to high debt levels and shadow bank financing should not be confused with undertaking measures to improve them. The Chinese government hopes that by steadying the ship first it will have both the resources and time to carry out this intricate balancing act once a new leadership team is in place in the autumn.

[4] Source: Sunday Morning Post, 5 March 2017.

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